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SUBJECT: MERCOSUL RIO DE JANEIRO SUMMIT: WHITHER MERCOSUL?

REF: 06 BRASILIA 1655

This cable is sensitive but unclassified, please protect accordingly.

¶1. (SBU) Summary: Mercosul members are facing more than the usual number of institutional challenges as they prepare for the bloc's biannual summit, to take place January 18-19 in Rio de Janeiro. In an implied slap at Mercosul dispute resolution mechanisms, Argentina recently requested WTO consultations over Brazil's imposition of anti-dumping duties on imports of Argentine PET resins. The ongoing Uruguay-Argentina dispute over the closure of a cross-border bridge by Argentine protestors opposed to Uruguay's construction of a cellulose plant on the border continues to fester. Brazilian businesses, faced with Argentine insistence on "voluntary trade restraints" on appliances and delays in implementing the automobile trade provisions of the bloc, are openly questioning their government's trade strategies. Meanwhile, the Brazilian government seems more focused on preparing a package of deliverables to assuage the very public complaints of the bloc's smallest members, Uruguay and Paraguay, that the trade grouping is not meeting their needs. The discussion of these institutional challenges likely will be overshadowed by Venezuelan President Hugo Chavez's recent declaration of socialism and Bolivia's application to upgrade its associate membership to full membership -- with special considerations. A trade agreement with the Gulf Cooperation Council (GCC) is likely to be signed. End Summary.

#### Institutional Challenges

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¶2. (SBU) The biannual Mercosul summit, to take place January 18-19 in Rio de Janeiro, will present Mercosul leaders with a series of institutional challenges. This is true at least from the point of view of the Brazilian foreign ministry (Itamaraty), for which Mercosul is a tool not only for regional economic and political integration, but also for the consolidation of what Brazil sees as its natural leadership role in the region. Given this view, Itamaraty, which dominates GoB Mercosul policy-making, often foregoes confrontation to try to shore up the unity of the bloc. Brazilian industry has complained loudly and almost completely ineffectually against the policy line Itamaraty has staked out in many Mercosul disputes, primarily involving Argentina.

13. (SBU) Brazilian industry frequently complains that Itamaraty is selling out hard Brazilian commercial interests for the mere appearance of Mercosul unity. They point to Argentina's extraction from the Brazilians of concessions to: a) delay the liberalization of the automotive trade regime between the countries; b) impose "voluntary restraints" on Brazilian exports of white goods and small appliances; and, c) Argentina's implied slap at Mercosul dispute resolution procedures in deciding to take Brazil to the WTO over the latter's imposition of anti-dumping duties on Argentine PET-resins. Meanwhile, the dispute between Uruguay and Argentina over the former's plans to build a cellulose plant on its border with the latter, continues to fester, also unaddressed by Mercosul dispute resolution mechanisms. The GoB, essentially, acquiesced to Argentina's insistence that Mercosul not address the problem. Brazilian Vice Minister of Foreign Affairs Samuel Pinheiro Guimaraes had a summit preparatory meeting recently with his Argentine counterpart in an attempt to work through many of the big issues.

#### BRAZIL SEEKS TO INJECT "GREATER COHESION"

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14. (SBU) The GoB is attempting to assure the success of the summit by putting together a package of deliverables, particularly for the smaller countries, which have been complaining recently about the bloc's lack of benefits and the manner in which Brazil and Argentina have decided major issues without consultation. President Lula reportedly instructed his ministers to find ways to eliminate bureaucratic hurdles to trade and give the bloc "greater cohesion." Foreign Minister Amorim told the press that his ministerial team is coordinating the effort. Lula met with six ministers shortly before departing on vacation, and they agreed to extend a USD 30 million credit to Bolivia for the purchase of 100 tractors. Also at the request of the Bolivians, the GoB is considering supporting the construction of a bio-diesel plant in Bolivia. Brazil also has

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agreed to consider Paraguay's request to re-negotiate the pricing structure for energy generated by the huge bi-national hydroelectric dam at Itaipu, although precisely how this will be done remains to be worked out as the pricing was part of a bilateral treaty.

15. (SBU) Lula reportedly also agreed to a proposal to facilitate trade with Uruguay by increasing the number of Customs officials at the border, thus speeding processing times and addressing a long-standing Uruguayan complaint. The GoB reportedly also will be loaning USD 20 million to Paraguay for customs systems improvements to enhance legitimate trade and improve Paraguayan customs' enforcement ability. Perhaps most significant will be a Brazilian undertaking to find a way to eliminate the double-charging of the Mercosul Common External Tariff (TEC) by Brazil on products initially imported into the customs union via Uruguay and Paraguay. (Note: If implemented, this would be a big step towards making Mercosul function more like a true customs union.) This would improve market access to Brazil for the smaller members.

#### Local Currencies to be Used in Argentine-Brazil Trade?

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16. (SBU) Also likely to be announced is the establishment by the Brazilian and Argentine central banks of a local-currency clearing house mechanism to facilitate payments on Argentina-Brazil trade. According to a Brazilian Central Bank contact, the clearing house would be aimed, at least initially, at enhancing market access by small businesses. These businesses find the costs of the current mechanisms, which require two foreign exchange transactions as the local currencies must first be converted first dollars and then into the currency of the trade partner, eat up much of the margin on their small import/export transactions. To this end, the central banks will set up a clearing house, guaranteed by a U.S. dollar account in a neutral institution (refitel). All currency trading would be settled daily so the central banks are not exposed to undue currency risk. Whichever central bank has a surplus in the other's currency at the end of the day would be paid in dollars from the guarantee account.

BOLIVIA APPLIES FOR FULL MEMBERSHIP

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¶17. (SBU) On the heels of Venezuela's recent entry into the bloc as a full member, President Evo Morales of Bolivia has been pressing for an answer to Bolivia's long-standing application for full membership in Mercosul. Bolivia, along with Chile, has been an associate member since 1996, as neither country was willing to adhere to the Mercosul Common External Tariff (TEC) given other trade commitments.

This is reportedly still an issue for Bolivia, which continues to ask that the TEC not be applied to it. Former Brazilian foreign minister Celso Lafer recently publicly criticized the idea of full membership for Bolivia without its first meeting the entry criteria, arguing that this would sharpen the institutional crisis created by Venezuela's recent "hasty" Mercosul accession.

#### MERCOSUL-GCC AGREEMENT

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¶18. (SBU) A trade agreement between Mercosul and the Gulf Cooperation Council (GCC) reportedly will be signed by the Mercosul leaders and GCC General Secretary Abdul Rahman, who is to participate in the summit. The text of the agreement, rules of origin and list of covered products were agreed upon during a December 2006 meeting in Riyadh. Negotiations on the agreement were launched during the 2005 Arab-South America summit in Brasilia.

#### A Parliament and Civil Society Representatives

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¶19. (SBU) The Mercosul summit also is expected to make progress towards the establishment of a regional parliament. Each of the five full Mercosul members will have power to nominate nine deputies, nine senators, and an equal number of back-ups (suplentes) to the Parliament. The idea is to progressively harmonize the trade legislation of the bloc, although it's not yet clear how this will be implemented. The first deputies of the Mercosul Parliament will have a four-year mandate. In addition, social movements, labor unions, and non-governmental organizations will be given a voice in

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certain Mercosul debates on integration by formalizing channels for direct communication between the member states' governments and civil society representatives.

¶10. (SBU) Comment: Mercosul is facing some difficult institutional issues, as its political dynamic is becoming increasingly detached from the economic integration agenda. But the summit in Rio de Janeiro will likely be dominated by Venezuelan President Chavez and his recent declaration of "socialism or death." The Brazilian government continues to calculate that the best way to moderate Chavez is by including him in regional fora and eschewing confrontation. Whatever influence they have gained over Chavez by including him in Mercosul, however, appears to be coming at substantial cost to the institution.

SOBEL